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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 02-960585
Gross Income Tax
For The Period: 1991 - 1993

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ISSUE

I. Gross Income Tax – Covenant Not to Compete

Authority: IC 6-2.1-2-2; 45 IAC 1-1-51; Indiana Dept. of Revenue v. Bethlehem Steel, 639 N.E.2d 264 (Ind. 1994).

The taxpayer protests the inclusion of income received from covenants not to compete.

STATEMENT OF FACTS

The assets of M, a division of E, were sold to company X in 1991. M had its administrative headquarters and a manufacturing plant located in Indiana. In the taxpayer's original return, they had reported all proceeds from the sale of this facility subject to gross income tax at the high rate. The taxpayer later filed an amended return reducing the proceeds reported by the amount attributed to the covenant not to compete.

E is an indirectly owned subsidiary of company B. Company E is a multistate corporation with a commercial domicile in Maryland. Corporation X is commercially domiciled in Missouri. The covenant not to compete is an agreement between B, E, and X whereby B and E agree not to enter into any business activity which would compete with products manufactured by M. The covenant was negotiated and consummated at offices outside of Indiana. The covenant proscribes B and E from engaging in specified business activities anywhere in the world (except Brazil). The covenant applies to B and all of its affiliates and applies to every state.

I. Gross Income Tax – Covenant Not to Compete

DISCUSSION

The auditor contends that since M's headquarters and manufacturing plant are located in Indiana, the covenant not to compete arose from the sale of an Indiana business. The auditor argues that regardless of where the intangible is held, there is a direct relationship of the income received from the intangible and the business activity in Indiana. The auditor further contends that M's commercial domicile is in Indiana per 45 IAC 1-1-51. The auditor concluded that the proceeds from the covenant not to compete were subject to gross income tax at the high rate.

The taxpayer in contrast argues that neither of the two tests set out in 45 IAC 1-1-51 is met, and therefore the covenant is not subject to gross income tax. 45 IAC 1-1-51 states that the "Department applies two tests in determining the taxability of income from intangibles." The first test is deemed the "business situs" test; the second separate test is "commercial domicile." Under business situs, if the intangible or the income derived therefrom "forms an integral part of a business regularly conducted at a situs in Indiana" then the total gross income derived from the sale will be required to be reported for taxation. 45 IAC 1-1-49 gives a non-exhaustive list of ways business situs may be established. After business situs has been established, the next prong of the first test in 45 IAC 1-1-51 requires "the intangible or the income derived therefrom" be connected with that situs. The taxpayer argues that even if the Department finds business situs, that the second prong is still not met, namely a connection between the situs and the income derived. The taxpayer characterizes the covenant as a forbearance, that is, it involves inaction by the Indiana division. The taxpayer also notes that the negotiations took place outside of Indiana.

Business situs is established by a number of means under 45 IAC 1-1-49. The use and operation of an office, factory, store, can establish situs. The maintenance of inventory of goods for sale, distribution or manufacture can establish business situs, as well as the ownership, leasing, or rental of income-producing property. The taxpayer meets the elaborated criteria of business situs. The next issue is whether the income derived from the intangible forms an integral part of business conducted in Indiana. Indiana Dept. of Revenue v. Bethlehem Steel, 639 N.E.2d 264, is pertinent to this stage of analysis. The facts in Bethlehem involved the sale of tax benefits under "safe harbor leases." Bethlehem Steel sold equipment, then had the equipment leased back to them by the buyer, and the only money exchanged was the proceeds from the sale of the benefits. The Indiana Supreme Court found that while the taxpayer was not commercially domiciled in Indiana, it nonetheless had business situs here. The court then stated that for purposes of IC 6-2.1-2-2 and 45 IAC 1-1-51, Indiana could only tax the benefits sold if they were "integrally related" to Bethlehem's Indiana plant. Id. at 271. The court enunciated various factors, other than the physical presence of the plant in the state, that could be taken into account to determine the sufficiency of the activity within Indiana: the domicile of the buyer and seller, where the agreement was negotiated, and where it was completed. Id. Given that none of the parties involved were Indiana corporations, none were commercially domiciled here, and the negotiations and consummation took place outside of Indiana, the Supreme Court affirmed the Tax Court's finding for Bethlehem.

The facts at hand are quite similar. None of the companies involved are Indiana corporations, none are domiciled here, and the negotiations took place outside of Indiana. In Bethlehem the Department relied upon the location of the plant within Indiana, and likewise here the auditor relies on the fact that M is located within Indiana. However the Indiana Supreme Court has made it clear that physical location within the state will not suffice for the purposes of 45 IAC 1-1-51.

With regard to the other means of taxing under 45 IAC 1-1-51—"commercial domicile"—none of the parties involved were commercially domiciled here. The auditor had characterized M as commercially domiciled in Indiana, but in actuality M was a division of another company (E)—which had its domicile elsewhere. Also, the company that purchased M (namely X) was domiciled in another state. Therefore the commercial domicile aspect of the regulatory code need not be analyzed.

FINDING

The taxpayer's protest is sustained.